



# The Federal Budget: Current and Upcoming Issues

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## Summary

The federal budget implements Congress's "power of the purse" by expressing funding priorities through outlay allocations and revenue collections. Over the past decade, federal spending has accounted for approximately a fifth of the economy (as measured by gross domestic product—GDP) and federal revenues have ranged between just over a fifth and just under a sixth of GDP. In FY2008, the U.S. government collected \$2.5 trillion in revenue and spent almost \$3.0 trillion. Outlays as a proportion of GDP rose from 18.4% in FY2000 to 20.9% of GDP in FY2008. Federal revenues as a proportion of GDP reached a post-WWII peak of 20.9% in FY2000 and then fell to 16.3% of GDP in FY2004 before rising slightly to 17.7% of GDP in FY2008.

The budget also affects, and is affected by, the national economy as a whole. Given recent turmoil in the economy and financial markets, the current economic climate poses a major challenge to policymakers shaping the FY2009 and FY2010 federal budgets. Federal spending tied to means-tested social programs has been increasing due to rising unemployment, while federal revenues will likely fall as individuals' incomes drop and corporate profits sink. As a result, federal deficits over the next few years will likely be high relative to historic norms.

In addition to funding existing programs in a challenging economic climate, the government has undertaken significant financial interventions in an attempt to alleviate economic recession. The ultimate costs of federal responses to this turmoil will depend on how quickly the economy recovers, how well firms with federal credit guarantees weather future financial shocks, and whether or not the government receives positive returns on its asset purchases. Estimating how much these responses will cost is difficult, both for conceptual and operational reasons.

Despite these budgetary challenges, many economists believe that fiscal policy (i.e., federal borrowing and spending) would be the most effective macroeconomic tool under current conditions. Past fiscal stimulus measures, which are being considered as possible options for 2009, have included extensions to unemployment benefits, aid to state and local governments, tax rebates, and expanded infrastructure spending.

Federal loans or loan guarantee programs may help provide liquidity to distressed financial markets and stimulate economic activity, but may also expose the federal government to substantial credit risks.

While many economists concur on the need for short-term fiscal stimulus, widespread concerns remain about the long-term fiscal situation of the federal government. The rising costs of federal health care programs and Baby Boomer retirements present serious challenges to fiscal stability. Operating these programs in their current form may pass on substantial economic burdens to future generations.

This report will be updated as events warrant.

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**T**he federal budget implements Congress's "power of the purse" by expressing Congress's funding priorities through outlay allocations and revenue collections. The budget also affects, and is affected by, the national economy as a whole. The federal budget over the next few fiscal years will likely face significant challenges to both revenues and outlays as a result of recent turmoil in the economy and financial markets.

Making budgetary decisions for the federal government is an enormously complex process, entailing the efforts of tens of thousands of staff persons in the executive and legislative branches, totaling millions of work hours each year. The budget process allows the President and Congress to negotiate and refine spending plans for the nation's fiscal priorities.<sup>1</sup>

The current budget situation is challenging. At the end of fiscal year (FY) 2008, the government was facing growing deficits, rising costs of entitlement programs, and significant spending on overseas military operations. The enactment of financial intervention and fiscal stimulus legislation designed to alleviate a credit crunch and to bolster the economy will push up the deficit, shifting fiscal burdens into the future. In addition, much of the government is operating under a continuing resolution for the first half of FY2009, and work to complete funding for FY2009 as well as developing the budget for FY2010 will be required of the incoming administration.

The economic downturn has not only pushed federal spending up and revenues down, but also threatens to slow economic growth for the next few years. The federal government has responded to the economic slowdown with an array of policy responses unprecedented in recent decades. Many economists believe a large fiscal stimulus is in order. Traditional monetary policy options have narrowed, leading many economists to believe that fiscal policy (i.e., federal borrowing and spending) would be a more effective macroeconomic tool under current conditions. Other federal interventions, such as loans or loan guarantee programs, may help stimulate economic activity and reduce dislocation in financial markets. These interventions, however, may also expose the federal government to substantial credit risks.

Substantial concern remains about the federal government's long-term fiscal situation. The rising costs of federal health care programs and the effects of the baby boom generation's retirement present serious challenges to fiscal stability. Operating these programs in their current form may pass on substantial economic burdens to future generations.

## Overview

### Revenues, Outlays, and Deficits for FY2008

Over the past decade, federal spending has accounted for approximately a fifth of the economy (as measured by gross domestic product—GDP) and federal revenues have ranged between just under a sixth and just over a fifth of GDP, as shown in **Figure 1**. In FY2008, the U.S. government collected \$2.5 trillion in revenue and spent almost \$3.0 trillion. Outlays as a proportion of GDP rose from 18.4% in FY2000 to 20.9% of GDP in FY2008. Federal revenues as a proportion of

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<sup>1</sup> For more information, see CRS Report 98-721, *Introduction to the Federal Budget Process*, by Robert Keith.

GDP reached a post-WWII peak of 20.9% in FY2000 and then fell to 16.3% of GDP in FY2004 before rising slightly to 17.7% of GDP in FY2008.

**Figure 1. Total Revenues and Outlays as a Percentage of GDP, FY1990-FY2010**



**Source:** CBO. Outlays for FY2008 are estimated; FY2009 and FY2010 are projected.

The annual budget deficit (or surplus) is revenue (i.e., taxes and fees) that the government collects minus outlays (i.e., spending).<sup>2</sup> The total deficit in FY2008 was \$455 billion, or 3.2% of gross domestic product, sharply higher than the FY2007 deficit of \$162 billion. The total deficit, according to some budget experts, gives an incomplete view of the government's fiscal condition because it includes Social Security surpluses (which are then held in Treasury trust funds until used to pay future benefits). Excluding off-budget items (Social Security benefits paid net of Social Security payroll taxes collected and the U.S. Postal Service's net balance) the federal deficit was \$638 billion.

<sup>2</sup> Most economists use data on federal outlays to track larger budget trends, while most program analysts use budget authority to track changes in specific program areas.

## Trends

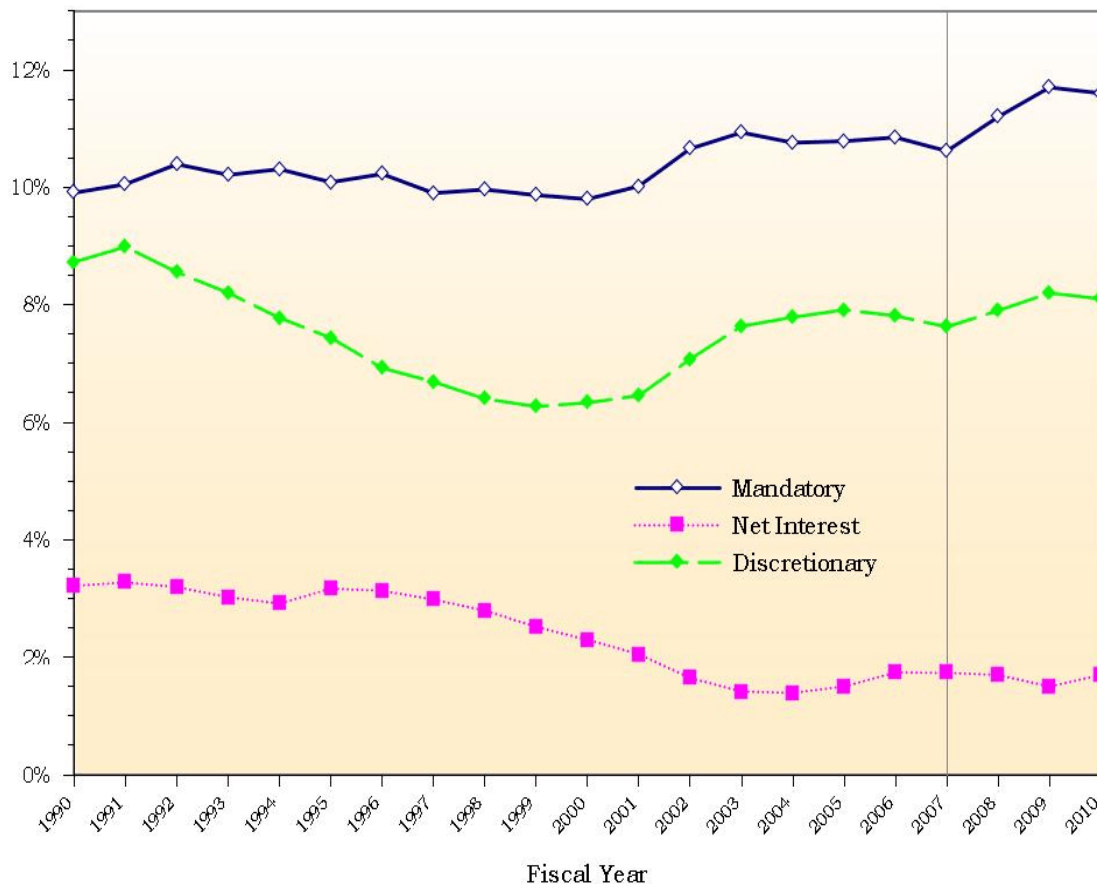
### Federal Spending

Budget enforcement legislation divides federal outlays into discretionary and mandatory spending, as well as net interest.<sup>3</sup> Discretionary spending flows from Congressional appropriations acts. Mandatory spending encompasses federal government spending on entitlement programs as well as other budget outlays controlled by laws other than appropriation acts.

Outlays rose from 18.4% of GDP in FY2000 to an estimated 20.9% of GDP in FY2008. As **Figure 2** shows, mandatory spending reached 11.2% of GDP in FY2008, comprising over half of total outlays. After falling in the 1990s, discretionary spending rose from 6.3% of GDP in FY2000 to an estimated 7.9% of GDP in FY2008. Over time, mandatory spending has generally grown faster than discretionary spending.

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<sup>3</sup> For more information on trends in discretionary and mandatory spending, see CRS Report RL34424, *Trends in Discretionary Spending*, by D. Andrew Austin and CRS Report RL33074, *Mandatory Spending Since 1962*, by D. Andrew Austin.

**Figure 2. Outlays by Type as a Percentage of GDP, FY1990-FY2010**

**Source:** CBO. Outlays for FY2008 are estimated; FY2009 and FY2010 are projected.

Discretionary outlays increased 5% a year on average in real terms from FY1999 to FY2008. The share of discretionary spending as a proportion of total federal outlays rose from 33.6% in FY1999 to an estimated 38.1% in FY2008. Higher defense outlays accounted for 75.6% of the increase in discretionary spending over the past decade. On average, from FY1999 to FY2008, defense outlays grew 8% per year in real terms, while real non-defense discretionary outlays grew 2.5% per year.

Entitlement programs such as Social Security and Medicare make up the bulk of mandatory spending.<sup>4</sup> Other mandatory spending programs include Temporary Assistance to Needy Families (TANF), Supplemental Security Income (SSI), unemployment insurance, veterans' benefits, federal employee retirement and disability, Food Stamps, and the Earned Income Tax Credit (EITC). Congress sets eligibility requirements and benefits for entitlement programs, rather than appropriating a fixed sum each year. Therefore, if the eligibility requirements are met for a specific mandatory program, outlays are made automatically.

<sup>4</sup> For more information see CRS Report RS20129, *Entitlements and Appropriated Entitlements in the Federal Budget Process*, by Bill Heniff Jr.



Over the past 40 years, mandatory spending has taken up a larger and larger share of the federal budget. In 1962, before the 1965 creation of Medicare and Medicaid, less than 30% of all federal spending was mandatory. At that time, Social Security accounted for about half of all mandatory spending. By FY2008, mandatory spending had grown to 54% of federal spending. Social Security, Medicare, and the federal share of Medicaid alone comprised over 40% of all federal spending, while discretionary spending totaled just under 40% in FY2008. Net interest payments accounted for an additional 8.7%.

Because discretionary spending is now at a historic low as a proportion of total federal outlays, some budget experts contend that any significant reductions in federal spending must include mandatory spending cuts. Other budget and social policy experts contend that cuts in mandatory spending would cause substantial disruption to many households because mandatory spending funds important parts of the social safety net.

## **Federal Revenue**

Individual income taxes have long been the largest source of federal revenues, followed by social insurance taxes. The amount of income tax revenue can vary substantially with changing economic conditions. In FY2008, individuals paid roughly \$1.1 trillion in taxes, or about 45% of total revenues collected. Corporate income taxes (\$304 billion), social insurance taxes (\$900 billion), and other taxes (\$173 billion) generated the remaining revenue. Individual income taxes as a percentage of GDP had been projected to rise slightly over the next 10 years, but forthcoming projections of future revenue growth will probably be less optimistic.

## **Deficits, Debt, and Interest**

The federal government's fiscal stance is often gauged by the annual budget deficit. The budget deficit, however, may give a partial and potentially misleading picture of the government's fiscal condition. Annual budget deficits or surpluses determine, over time, the level of federal debt and affect the growth of interest payments to finance the debt.

### **Federal Deficits**

Deficits can serve as a powerful instrument of fiscal policy. Occasional deficits, in and of themselves, are not necessarily problematic. Deficits can be used to let governments smooth outlays and taxes, so that taxpayers and program beneficiaries are shielded from abrupt economic shocks. Persistent deficits, on the other hand, lead to growing accumulations of federal debt that are passed along to future generations.

### **Federal Debt**

Gross federal debt is composed of debt held by the public and intragovernmental debt. Intragovernmental debt is the amount owed by the Federal government to other federal agencies, to be paid by the Department of the Treasury. This amount largely consists of money contained in trust funds, such as Social Security, that has been invested in Federal securities as required by

law.<sup>5</sup> Debt held by the public is the total amount the Federal government has borrowed from the public and remains outstanding. This measure is generally considered to be the most relevant in macroeconomic terms because it is the amount of debt sold in credit markets.

Changes in debt held by the public generally track the movements of the annual on-budget deficits and surpluses. Whether or not the movements of gross federal debt will follow those of debt held by the public depends on how intergovernmental debt changes. Higher debt levels could slow investment and lower economic growth.

## **Debt Limit**

Congress sets a ceiling on federal debt through a legislatively established limit that helps Congress assert its constitutional prerogative to control spending. The debt limit also imposes a form of fiscal accountability that compels Congress and the President to take visible action, in the form of a vote authorizing a debt limit increase, to allow further federal borrowing when nearing the statutory limit. The debt limit can hinder the Treasury's ability to manage the federal government's finances when the amount of federal debt approaches this ceiling. In those instances, the Treasury has had to take unusual and extraordinary measures to meet federal obligations.<sup>6</sup> While the debt limit has never caused the federal government to default on its obligations, it has caused inconvenience and uncertainty in Treasury operations at times. Currently, the debt limit stands at \$11,315 billion.<sup>7</sup> As of December 3, 2008, federal debt subject to limit equaled \$10,611 billion.<sup>8</sup>

## **Net Interest**

In FY2008, the U.S. spent \$260 billion, or 1.8% of GDP, on net interest payments on the debt. What the government pays in interest depends on market interest rates as well as on the size and composition of the federal debt. Since FY1968, the U.S. spent an average of 2.2% of GDP on interest payments. In FY2004, interest payments dipped to a low of 1.4% of GDP, but have since increased. If the value of the federal debt in real terms were to grow faster than the economy, the burden of paying interest on the debt would grow as well.

## **Budget Cycle**

A single year's budget cycle takes roughly three calendar years from initial formation by the Office of Management and Budget (OMB) until final audit. The executive agencies begin the budget process by compiling detailed budget requests during the winter, nearly a year before the fiscal year begins. OMB oversees the development of these agency requests. The President, by law, must submit a budget, which is based on OMB's work, by the first Monday in February.

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<sup>5</sup> U.S. Executive Office of the President, Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2009, Analytical Perspectives*, Feb. 2008, p. 408.

<sup>6</sup> General Accountability Office, *Debt Ceiling: Analysis of Actions Taken During the 2003 Debt Issuance Suspension Period*, GAO-04-526, May 20, 2004.

<sup>7</sup> For more information, see CRS Report RL31967, *The Debt Limit: History and Recent Increases*, by D. Andrew Austin and Mindy R. Levit.

<sup>8</sup> U.S. Department of Treasury, Financial Management Service, *Daily Treasury Statement*, available at <http://fms.treas.gov/web services/show/?ciURL=/dts/08120300.pdf>, accessed on December 5, 2008.

Because this date follows Inauguration Day so closely, the incoming President has little time to compile budget documents. In past decades, some new presidents have relied on their predecessors' budget teams to outline a budgetary framework for submission in February and then submit their own budget or revisions at a later date.<sup>9</sup> This option may be unavailable to the Obama Administration because, in 2008, OMB instructed agencies that, due to the upcoming presidential transition, budget submissions were not required.

During the fiscal year, which begins on October 1, Congress and OMB oversee the execution of the budget. Once the fiscal year ends on the following September 30, the Treasury Department and the Government Accountability Office (GAO) begin year-end audits.

## **Budget Baseline Projections**

The Congressional Budget Office (CBO) provides data and analysis to Congress throughout the budget and appropriations process. Each January, CBO issues a *Budget and Economic Outlook* that contains current-law baseline estimates of outlays and revenues. In March, CBO issues an analysis of the President's budget submission with revised baseline estimates and projections. OMB issues a *Mid-Session Review* in July with budget data revised to reflect changes in policy proposals, changed economic conditions, and other factors. In late summer, CBO issues an updated *Budget and Economic Outlook* with new baseline projections.

The CBO current-law baseline sets a benchmark to evaluate whether legislative proposals would increase or decrease outlays and revenue collection. Baseline estimates are not intended to predict likely future outcomes, but to show what spending and revenues would be if current law remained in effect. CBO typically evaluates the budgetary consequences of legislative proposals and the Joint Committee on Taxation (JCT) evaluates the consequences of revenue proposals.

CBO computes baseline projections using certain assumptions set in law.<sup>10</sup> Forecasts based on these assumptions typically yield higher revenue estimates and slower growth of discretionary spending relative to scenarios independent forecasters consider likely. More specifically, CBO baseline projections incorporate three legislatively mandated assumptions: that discretionary spending remains constant in inflation-adjusted terms, that the 2001 and 2003 tax cuts fully expire after 2010 (as current law specifies), and that one-year "patches" to the alternative minimum tax (AMT) will lapse even though past Congresses have extended AMT patches year after year. Macroeconomic assumptions, namely the point at which CBO expects the recession to end, will also affect the baseline estimates and projections especially given the current economic climate.

Previous baseline projections showed substantial growth in receipts after 2010, when most of the tax cuts from 2001 and 2003 expire. Federal deficits are expected to grow rapidly beyond the 10-year forecast window unless major policy changes are made, however, largely because of increased outlays due to rapidly growing health care costs and Baby Boomer retirements.

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<sup>9</sup> Additional information on budget during transition is available in CRS Report RS20752, *Submission of the President's Budget in Transition Years*, by Robert Keith.

<sup>10</sup> While some budget enforcement legislation constraining the computation of CBO baseline estimates has expired, CBO has continued to follow those legislative guidelines.

## **Budgeting in Tough Economic Times: the FY2009 and FY2010 Budgets**

Aside from the specific issues related to the budget in Presidential transition years, the current economic climate poses another major challenge to policymakers shaping the FY2009 and FY2010 federal budgets. Federal spending tied to means-tested social programs has been increasing due to rising unemployment, while federal revenues will likely fall as individuals' incomes drop and corporate profits sink.

### **Financial and Economic Turmoil**

Financial markets have been in turmoil since August 2007. That turmoil intensified in March 2008 when the investment bank Bear Stearns was forced to sell itself to Morgan Stanley, and intensified again on September 7, when government-sponsored mortgage guarantors Fannie Mae and Freddie Mac were placed into conservatorship. A week later, on September 15, the investment bank Lehman Brothers declared bankruptcy. The insurance giant AIG avoided a similar fate only by obtaining an \$85 billion loan from the federal government. In December 2008, the National Bureau of Economic Research (NBER) determined the U.S. economy has been in a recession since December 2007. Many experts believe that other financial institutions as well as other large firms could fail before the recession ends.

### **Federal Response to Turmoil in 2008**

The federal government has responded to this financial turmoil with an extraordinary set of measures. In February 2008, Congress enacted a \$152 billion package (P.L. 110-185, Economic Stimulus Act of 2008) to stimulate consumption that sent refunds to taxpayers and let firms depreciate their capital more quickly. Later in the year, the Federal Reserve created a panoply of lending facilities, such as the Term Auction Facility (TAF), the Primary Dealer Credit Facility (PDCF), and the Term Securities Lending Facility (TSLF) among others. These facilities provide financial institutions with loans in exchange for various types of collateral.

On October 3, Congress passed the Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343), which authorized the Treasury Secretary to use \$700 billion (subject to certain Congressional restrictions and notifications) to intervene in financial markets or to inject capital into key financial institutions as part of a Troubled Assets Relief Program (TARP). While Treasury Secretary Henry Paulson first proposed using TARP funds to buy mortgage-related securities, those plans were later shelved. Instead, the Treasury Department injected TARP funds to recapitalize banks and financial institutions by acquiring preferred shares. On November 12, Paulson announced that a portion of TARP would fund a new Federal Reserve collateralized lending program, the Term Asset-Backed Securities Loan Facility (TALF), which will take in securities based on "newly and recently originated" loans, such as for education, automobiles, and credit cards.

### **Adding up the Cost of Federal Interventions**

The size, variety, and complexity of federal responses to financial and economic turmoil present many challenges to budget analysis. The ultimate costs of these responses will depend on how the

economy performs, how well firms with federal credit guarantees weather future financial shocks, and whether or not the government receives positive returns on its asset purchases. Estimating how much these responses will cost the federal government is difficult, both for conceptual and operational reasons.

### **What Counts As an Outlay?**

The distinction between outlays and budget authority is important to understanding the budgetary consequences of federal responses to economic and financial turmoil. Outlays are disbursed federal funds. Budget authority is what federal agencies can legally spend. Budget authority has been compared to funds deposited into a checking account, which then can be used for federal purposes. Until the federal government disburses funds to make purchases, however, no outlays occur. Giving federal officials the ability to spend requires budget authority. Outlays will not increase until those funds are actually disbursed.

Outlay data are used to assess the macroeconomic effects of the federal budgets, while budget analysis of specific federal programs is typically based on budget authority figures. Appropriations legislation is generally framed in terms of budget authority because that is what Congress can most directly control.

As of November 2008, Treasury has spent approximately \$330 billion of the \$700 billion allocated by Congress through TARP. Outside of the TARP, other federal agencies have also used their statutory authority to provide relief to the financial sector and credit markets in various ways. Estimating the precise budgetary impact of these programs is difficult. In addition, CBO and OMB disagree over the budgetary treatment of some programs. For example, much of the early amounts of TARP funds have been used to purchase preferred equity stakes in major banks. CBO has contended that EESA requires those equity purchases to be costed on a net present value basis, so that the future sale of those equity stakes would offset much of the cost of acquiring them. OMB has argued for a cash basis approach, so that those equity purchases would increase the federal deficit for FY2009 and future sales would reduce deficits in future years as those equity stakes are sold off. Thus, the difference between CBO and OMB approaches could affect the timing of how hundreds of billions of dollars are reflected in budgetary accounts.

The final scope of many elements of the financial intervention programs remains unclear given that the Treasury Secretary has been granted wide discretion in how to use these funds. The ultimate costs and budgetary implications depend on how long the recession lasts and what, if any, additional federal resources are put toward dealing with the current economic and fiscal issues with or without additional Congressional action.

### **Current Federal Budget Scoring Ignores Some Credit Risks**

The federal government has provided credit guarantees to several firms to reduce systematic financial or economic risks to the economy. The cost of making these guarantees to the government, however, may be much less than the value of the guarantees. If economic conditions improve soon, those credit guarantees will not result in new federal outlays. On the other hand, if the economic conditions deteriorate, the government may face major losses. The Federal Credit Reform Act of 1990 (FCRA) requires that the reported budgetary cost of credit programs equal

the estimated subsidy cost at the time the credit is provided.<sup>11</sup> FCRA, however, omits risk adjustments in subsidy calculations.<sup>12</sup> The true economic cost of federal credit guarantees can be substantially underestimated when risk adjustments are omitted.<sup>13</sup>

Some economists argue that the federal government should not charge for the risks it accepts. That argument, however, properly applies only to diversifiable risks—that is, risks that can be minimized by pooling small risks. For non-diversifiable risks, such as systematic risks to financial markets, governments may spread or redistribute risks, but cannot eliminate them via pooling. Some argued that because the U.S. government can borrow at a risk-free rate, that budget accounting for federal credit programs should not include a risk premium.<sup>14</sup> The U.S. Treasury’s ability to borrow funds cheaply, however, derives from the government’s ability to tax. The U.S. government can borrow at a risk-free rate not because it can eliminate risks, but because it can transfer risks to taxpayers and program beneficiaries.<sup>15</sup>

Federal responses to financial turmoil and the recession may expose the government to significant credit risks. Large amounts of difficult-to-value financial assets have been put on the Treasury and Federal Reserve balance sheets. Estimating scale and market cost of those risks is difficult because the way some programs will be administered is unclear. Potential costs also depend on how quickly the economy recovers and how the structure of financial markets evolves.

## **Budget Fiscal Year 2009**

The CBO and OMB baseline budget estimates of federal spending and revenues for FY2009 and beyond, issued in summer 2008, were rendered largely obsolete by

recent economic issues and resulting legislation enacted to reduce the impact of the housing and credit crises. Financial turmoil and the recession will also affect outlay and revenue projections over the next several years. Moreover, additional measures, such as a new fiscal stimulus package, would strongly affect how much the government spends and taxes in the nine months of FY2009 that will remain when the 111<sup>th</sup> Congress starts. In addition, many of the non-defense discretionary spending programs are now operating under a continuing resolution. Estimating outlays when continuing resolutions are in effect presents special technical difficulties.

During the past several budgetary cycles, Congress did not pass all of the regular appropriations bills, which determine discretionary spending, before the start of the fiscal year. The FY2009

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<sup>11</sup> The Federal Credit Reform Act of 1990 was created as part of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508). FCRA defines a subsidy cost as “the estimated long-term cost to the government of a direct loan or a loan guarantee, calculated on a net present value basis, excluding administrative costs.” For details, see CRS Report RL30346, *Federal Credit Reform: Implementation of the Changed Budgetary Treatment of Direct Loans and Loan Guarantees*, by James M. Bickley.

<sup>12</sup> While the FCRA calculations include estimates of default costs, they do not discount more volatile income flows, as a private firm would.

<sup>13</sup> U.S. Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, Aug. 2004, available at <http://cbo.gov/doc.cfm?index=5751>.

<sup>14</sup> U.S. government is widely regarded as having no default risk, although government securities may carry other risks, such as interest rate risks and for foreign holders, exchange rate risks.

<sup>15</sup> U.S. Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, Aug. 2004, p. 4.

budget cycle was no exception. Congress provided its budgetary outline in the budget resolution adopted in early June 2008, which called for \$1,183 billion in discretionary spending and \$1,883 billion in mandatory spending. Although the budget resolution is not law, it constrains spending plans and thus plays a central role in determining budgetary outcomes.<sup>16</sup> Regular appropriations bills for Defense, Homeland Security, and Military Construction were included in the Consolidated Security, Disaster Assistance, and Continuing Appropriations Act of 2009 (P.L. 110-329), which was signed into law on September 30, 2008, the day before the start of FY2009. The Act also provides continuing appropriations for other parts of the government until March 6, 2009. Congress must pass the remaining appropriations bills for the rest of the fiscal year or pass another continuing resolution before that date to avoid a shutdown of government agencies. Mandatory outlays and federal taxes, however, would continue.

According to media reports, Congressional leaders plan to roll the remaining appropriations bills into an omnibus measure that the new Congress would consider in early January, allowing the new President to take immediate action after Inauguration Day. The annual deficit, in current dollar terms, may set a record due to a slowdown in revenues and large increases in outlays, although federal deficits during World War II, when adjusted for inflation, were larger.

## **War Funding**

Costs of wars in Iraq and Afghanistan have been funded for the most part by emergency supplemental appropriations since 2001. By contrast, most of the funding for the Vietnam war after the first few years was provided in regular appropriations.<sup>17</sup> Since 2004, war funding has been requested in two parts: an emergency “bridge” fund to cover the first part of the year that has been included in the Department of Defense’s (DOD) regular appropriations and a supplemental that has been submitted later in the fiscal year. The Supplemental Appropriations Act, FY2008 (P.L. 110-252) provided both the second part of war funding for FY2008, in the amount of \$66 billion, and the first part for FY2009. The FY2009 funding is expected to finance military operations until June or July 2009.<sup>18</sup>

According to press reports, the current Administration may submit a FY2009 supplemental covering the rest of the current fiscal year, though Congress is unlikely to respond to such a request. A war funding request from the new Administration for the rest of FY2009 would be expected to reflect its decisions about future troop levels in both Iraq and Afghanistan.<sup>19</sup>

Supplemental war appropriations complicate the budget process. First, some argue that war funding should be included in DOD’s regular appropriations. DOD and others have suggested that war costs remain fluid and that combining regular and war funding could make segregating those funds more difficult. Some contend that the outgoing Bush Administration used supplemental

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<sup>16</sup> The Congressional Budget Act sets April 15 as a target date for Congress to adopt a budget resolution. In some years, that target date was not met. For more information see CRS Report 98-814, *Budget Reconciliation Legislation: Development and Consideration*, by Bill Heniff Jr.

<sup>17</sup> CRS Report RS22455, *Military Operations: Precedents for Funding Contingency Operations in Regular or in Supplemental Appropriations Bills*, by Stephen Daggett, pp. 5-6. For a discussion of how war funding may affect the federal budget, see CRS Report RL31176, *Financing Issues and Economic Effects of American Wars*, by Marc Labonte and Mindy R. Levit.

<sup>18</sup> CRS Report RL33110, *The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11*, by Amy Belasco, p. 2.

<sup>19</sup> Inside Defense, “DoD Finishing \$80 Billion War Spending Request; \$50 Billion for New Hardware,” Nov. 24, 2008.

appropriations to obscure the costs of wars in Iraq and Afghanistan to the public. Second, the irregular timing of supplemental appropriations requests complicates comparisons of baseline budget forecasts. CBO current-law budget baseline projections extrapolate discretionary spending levels, including already enacted emergency war funding. War funding that is not yet enacted, even if military and budget experts were to judge such spending unavoidable, is not included in baseline budget projections. Therefore, baseline projections run just after a supplemental appropriations bill is passed probably exaggerate true annual costs, while baseline projections run just before such a bill probably overstate DOD's ongoing peacetime costs and understate full annual costs, including war funding. Finally, many in Congress have questioned whether after seven years, war appropriations are appropriately categorized as "unanticipated" emergencies not subject to caps in annual congressional budget resolutions. Although Congress required a full year's war request starting in FY2008, the Administration failed to submit one for FY2009 (Sec. 1007, P.L. 110-364).

## **The Budget and Macroeconomic Policy**

Governments typically strive to keep economic growth steady and employment high while maintaining a stable price level. Macroeconomic policy instruments are often divided into three components: monetary policy (i.e., control of monetary base and short-term interest rates), fiscal policy (government borrowing and spending), and structural factors. While these standard macroeconomic policy tools have been highly effective in moderating economic fluctuations over the past few decades, the financial turmoil and credit crunch in FY2009 present special challenges that may require other types of government responses.

### **The Limits of Monetary Policy**

Monetary policy has several important advantages in macroeconomic stabilization. The Federal Reserve, the central bank of the United States, can deploy traditional monetary policy tools such as open-market interventions and control of short-term federal interest rates. The independence of the Fed insulates it from political pressures and allows it to act quickly in response to new developments in the economy. The Fed, in conjunction with the Treasury Department, developed innovative responses to the financial turmoil that broke out in August 2007. As economic problems deepened in 2008, the Fed redoubled its efforts to unfreeze critical areas of credit markets.

In the current economic situation, traditional monetary policy initiatives appear to have neared their effective limits. Declining investment demand and investors seeking a safe harbor for funds have pushed short-term interest rates on federal securities to very low levels. Efforts to push those interest rates even lower might spur little additional lending when banks and other lenders worry about the solvency of financial counterparties. Monetary policy loses much of its effectiveness in such a "liquidity trap," as banks' reluctance to lend frustrates the Fed's efforts to expand the money supply. Moreover, while new Federal Reserve lending facilities may improve credit conditions or at least limit further deterioration, those programs were not designed to address the larger macroeconomic issue of stimulating economic growth. Finally, while the Fed responses in 2008 have been aggressive and creative, there may be limits to what additional programs can accomplish.



## Logic of Fiscal Stimulus

The context for fiscal policy begins with national income accounting. The national income, as measured by GDP, is the sum of expenditure categories. Specifically, the national income accounting identity is

$$Y \equiv C + I + G + \text{Net Exports}$$

where

Y = national income (GDP)

C = private consumption

I = private investment

G = government spending.

The identity implies that national income falls when private consumption and investment fall unless offset by increases in either government spending or net exports. In the current economic environment, government spending increases have become the focus of attention as a source of stimulus as consumption and investment continue to decline.

Private consumption fell sharply in 2008 for several reasons. Rising unemployment rates left some households with lost earnings, and prompted others to increase savings to cushion against possible future job losses. Some households that had borrowed using home equity credit lines, credit cards, or other types of credit became unable to continue borrowing, thus requiring cutbacks in consumption. Other households became unable to afford mortgage payments, contributing to increasing foreclosure rates and reducing consumption. Auto sales, an important component of private consumption, fell drastically as financing became harder to obtain and gas prices rose in mid-2008. Few economists expect consumption to rebound in the near term.

Private investment falls when businesses believe that demand for what they sell is falling or will fall. Non-residential investment, a component of private investment, has been weak relative to historical levels since the mid-1990s, although information technology investment was strong until the collapse of dot-coms in 2000. The Federal Reserve then sharply lowered short-term interest rates. Capital inflows, especially from East Asia, pushed down market interest rates. Low interest rates helped housing prices rise and stimulated new residential construction and development, boosting fixed residential investment.

As housing prices in many areas of the country reached their peak or began to decline in 2007, investors who once had thought that home prices would continue to rise backed away. Additionally, many investors began to fear that residential mortgage-backed securities (RMBS) were much riskier than anticipated, and capital markets became reluctant to put more money into the residential sector. A credit crunch, partially sparked by concerns over RMBS, emerged in August 2007. Foreclosure rates have climbed, as refinancing options for many homeowners dwindled, putting added downward pressure on home prices. High levels of fixed residential investment over the past decade have created large inventories of new houses, which may dampen incentives for future construction. All of these variables contributed to declines in private investment, which are not expected to reverse in the near term.

The United States has run trade deficits since the mid-1980s. In recent years, the trade deficit has narrowed (so that net exports are less negative) in part because the dollar has weakened relative to

most major currencies. Sharply higher energy prices in 2008 offset many of those gains, but falling energy prices in late 2008 may help shrink the trade deficit further. As trading partners have begun to face their own economic problems, demand for American exports may fall. American consumers, however, may buy fewer imported goods during the recession. The combined effect on net exports is likely to be mixed, causing them to be an ineffective source of stimulus.

Most macroeconomists believe that reductions in private consumption and investment will cut economic growth unless debt-financed government spending increases to provide substantial fiscal stimulus. Other measures, such as investment incentives or broad tax cuts may also promote economic growth, although some economists believe debt-financed government spending is a more effective stimulus to aggregate demand in a recession.

### ***Applying Fiscal Policy***

Standard applied macroeconomic theory suggests that fiscal policy is more effective when short-term interest rates are extremely low. Fiscal policy therefore plays an especially important role in economic policy during economic downturns. The amount and composition of the federal spending along with the size of the federal deficit are key fiscal policy instruments.

During economic downturns, government revenues fall and expenditures rise as more people become eligible for unemployment insurance and income support programs, causing deficits to increase or surpluses to shrink. These effects, known as “automatic stabilizers,” provide a countercyclical stimulus in the short run without the need for new legislative action. Automatic stabilizers, however, probably cannot provide enough fiscal stimulus to pull the current economy out of a recession.

Higher government spending financed by borrowing, above and beyond the automatic stabilizer effects, provides a powerful fiscal policy tool that can help counteract recessions. A countercyclical fiscal policy, in which taxes are cut or spending is increased, can dampen economic fluctuations and limit the depth of economic downturns.

Debt-financed government spending is one component of Keynesian demand management—the theory that government can stabilize the economy, or at least moderate economic fluctuations by using fiscal policy to offset changes in private consumption and investment. The federal government, according to that theory, can shift buying power from future to the present more easily than firms and households, and is therefore better able to maintain stable economic conditions.

Reducing government deficits when economic growth is robust is the other key component of demand management. In this respect, responsible fiscal policy requires that spending in economic downturns be paid for by future spending reductions and/or tax increases. These actions, however, will reduce private consumption or investment in the future.

### ***Caveats Regarding Fiscal Stimulus***

Some economists have criticized the logic of Keynesian demand management and the discretionary application of fiscal spending by governments. Some have contended that Keynesian fiscal policy arguments do not take sufficient account of choices made by firms and

individual households. Others argue that Keynesian demand management policies can create administrative problems and note that mustering the political will to maintain a sustainable fiscal policy by reducing spending over the economic cycle can be hard.

Some economists have argued that not just the government, but also households can shift spending through time via borrowing and saving. Thus households, according to some, may counteract government fiscal policies by saving during economic downturns, thus further reducing consumption. Other economists note that many households are not in a position to choose between saving and consuming and that the low interest rates typically found in economic downturns may weaken incentives to save. Some evidence suggests that high-income households may take savings measures that offset government fiscal policies, but low-income households are, in general, less able to rearrange their finances in ways that would reduce the effectiveness of fiscal policy.

The argument for Keynesian demand management presumes that governments run surpluses during economic expansions to repay debt accumulated when applying fiscal stimulus during economic downturns. Critics of deficit-financed fiscal policy argue that policymakers are more willing to raise government spending when economic growth slows than to cut spending when growth accelerates.<sup>20</sup> Certain federal programs or increased spending, enacted during economic downturns, may remain in place after they are no longer necessary because of the interests of influential beneficiaries rather than overall economic welfare. On the other hand, some programs created during the Great Depression such as Social Security, have helped make many families less vulnerable to economic shocks.

Few economists believe that large changes in fiscal policy designed to counterbalance short-term economic downturns can be timed precisely. Certainly, macroeconomists are more skeptical about the ability to fine-tune fiscal policy than their predecessors a generation ago. Most macroeconomists nonetheless believe fiscal policy is an important tool during deep or prolonged periods of slow or negative growth.

## Considerations for Congress

Congress faces extraordinary budgetary challenges in FY2009 with both short-run and long-run budget priorities that may conflict in critical ways. In the short term, economic issues may dominate policy debates, creating pressure for higher deficit spending. In the long term, increasing federal health care costs are expected to keep mandatory spending rising.

Congress and the President must decide how to fund much of the non-defense discretionary spending after the current FY2009 continuing resolution expires on March 6, 2009. The new president will also propose a FY2010 budget. Due to the transition, budget details might be unavailable in early February, thus effectively compressing the Congressional budget cycle and shortening the time available for Congress to review budget proposals. Funding requests for military operations in Iraq and Afghanistan will likely continue. New shocks to the financial system and the economy may present Congress with new demands for federal responses. Congressional oversight of existing economic stabilization programs may require the additional attention of policymakers.

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<sup>20</sup> Milton Friedman, *Capitalism and Freedom*, (Chicago: Univ. of Chicago Press, 1962), pp. 75-84.

## **Short-Term Considerations**

Congress may choose to enact more government spending in response to the state of the economy. While the power of debt-financed government spending to provide fiscal stimulus is independent of how those funds are spent, clearly taxpayers and beneficiaries of federal programs gain more when that spending reduces households' economic vulnerabilities or promotes future economic efficiency. Past fiscal stimulus measures have included extended unemployment benefits, aid to state and local governments, tax rebates, expanded infrastructure spending, and interventions in financial institutions.

Congressional leaders, according to media reports, are also mulling over a second economic stimulus that could reach as high as \$700 billion in new spending. The plan could fund new investment in green technology as well as support for state and local governments in the form of infrastructure spending and additional Medicaid funding.

Apart from any additional stimulus spending, the U.S. auto industry, facing the worst downturn in auto sales in 15 years and a significant loss in market share, has asked for \$34 billion in loans through TARP or through other means to revitalize and restructure their companies. General Motors and Chrysler have said they will likely have to file for bankruptcy protection if they fail to receive federal aid. The cost of this assistance, if granted, is not yet estimated.

## **General Budget Issues**

Congress may wish to consider some general budgeting issues beyond short term considerations of annual funding requests and fiscal stimulus.

## **Managing Federal Credit Risks**

FCRA requires that federal loan and credit program costs be recorded on a net present value basis. The calculations mandated by FCRA, while an advance over previous practices, do not take into account risks borne by the federal government, and indirectly, risks borne by taxpayers and program beneficiaries. Federal responses to economic and financial turmoil expose the government to substantial credit risks. Congress may opt to consider methods to undertake a systematic accounting of risks undertaken by government activities.

## **Stimulate and Stop**

Large-scale fiscal stimulus and aggressive measures to limit systematic risks in financial markets may be needed to limit serious damage to the economy and the structure of capital markets. On the other hand, debt-financed fiscal stimulus measures eventually must be paid for through higher taxes or future cuts in government programs. Banks and other financial institutions must eventually be weaned off Federal Reserve and Treasury borrowing facilities. After the economic recovery begins, Congress may use oversight authority to rein in spending as soon as is appropriate.

## **Budget Transparency**

The budget, reflecting the size and complexity of the federal government, is complicated and detailed. The budget books that OMB compiles provide an enormous amount of information, and other budget data reported by federal agencies provide even more detail on federal spending plans. The Federal Funding Accountability and Transparency Act of 2006 (P.L. 109-282) included several measures to increase the accessibility of budget information. For example, as a result of that act, OMB now runs the USAspending.gov website, which provides detailed information on federal spending. Some, however, have raised concerns about quality of those data. Moreover, it is not clear that those data are thoroughly coordinated with other federal budgeting data systems.

In certain cases, despite the large amount of data provided by OMB and other government agencies, it can be difficult to answer relatively simple budget questions. Critics maintain that the federal government in general and OMB in particular should take steps to make data on federal spending more transparent to taxpayers and more useful to policymakers. In addition, budget data related to war costs could be made more transparent. Congress may consider requiring these changes to provide more organized and transparent budget data to citizens and to itself.

## **Budget Enforcement Measures**

The Budget Enforcement Act and other budget enforcement legislation was widely credited for laying the groundwork for the federal government's surpluses in the late 1990s. The Budget Enforcement Act, which imposed certain "Pay-as-you-go" (PAYGO) rules, expired in 2002. PAYGO rules discourage or prevent the enactment of mandatory spending and revenue legislation that is not deficit neutral, i.e., legislation that would cause, or increase, a deficit or reduce a surplus.<sup>21</sup> While the House and Senate in the 110<sup>th</sup> Congress have modified forms of PAYGO procedures, the 111<sup>th</sup> Congress may consider broader measures to ensure budgetary discipline. When the economy starts to grow again, attention may turn to deficit reduction efforts, in which case PAYGO procedures could become more important.

## **Long-Term Considerations**

Annual budget deficits or surpluses are not always the best indication of long-term fiscal stability. Most economists agree that, under certain conditions, running a budget deficit may be necessary to provide economic stimulus or pull an economy out of recession. A large budget deficit, in itself, does not necessarily indicate a longer term problem. The federal government, however, faces serious long-term budget challenges. Some measures of fiscal solvency in the long term indicate that the U.S. may face a major future crisis, specifically as it relates to rising healthcare costs and the likely impact on government financed health care spending.

CBO, GAO, and OMB agree that the current mix of federal fiscal policies is unsustainable in the long term. The nation's aging population, combined with rising health care costs per beneficiary, seems likely to keep federal health costs rising faster than per capita GDP. CBO has concluded that "under any plausible scenario, the federal budget is on an unsustainable path," extending well into this century.

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<sup>21</sup> See CRS Report RL34300, *Pay-As-You-Go Procedures for Budget Enforcement*, by Robert Keith.

Keeping future federal outlays at 20% of GDP, approximately its current share, and leaving fiscal policies unchanged, according to CBO projections, would require drastic reductions in all spending other than that for Medicare, Social Security, and Medicaid. A former CBO Acting Director stated that, “by 2030 ... spending for those programs [Medicare, Social Security, and Medicaid] is projected to reach roughly 15 percent of GDP.... If that increase happened ..., the rest of the budget would have to be cut by more than half” to keep overall spending close to its current level. The Administration indicated similar concerns about the outlook for the budget over the long term in the President’s FY2009 budget.

The Social Security, Medicare, and Medicaid programs present different challenges to the long-term fiscal position of the federal government. Estimates of the long-term fiscal gap between Social Security (OASDI) outlays and Social Security revenues as a proportion of long-term GDP are generally much smaller than estimates of the long-term fiscal gap between Medicare (HI, Part B, and Part D) outlays and revenues as a portion of long-term GDP. These long-term estimates of fiscal imbalances are sensitive to changes in assumptions regarding productivity growth and interest rates. Spending projections for Medicare and Medicaid are sensitive to medical inflation. Past projections that medical inflation would slow turned out to be overly optimistic.

When the economy recovers, Congress may focus more effort on balancing the budget and reining in the debt. This would require less spending, increases in revenue collections, faster than average economic growth, or a combination of these things. Many economists agree that having some federal debt is a good thing because it builds credit which allows for more favorable borrowing terms. It encourages investment within the country because federal debt is seen as relatively low-risk and safe. Debt is not free, however, and requires interest payments that strain budgets. High debt levels could limit the government’s flexibility in meeting its obligations or in responding to emerging needs of its citizens. Ultimately, failing to take action to reduce the projected growth in the debt potentially might lead to future insolvency or government default.

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